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Foreign Direct Investment in Developing Countries

Patterns, Policies, and Prospects

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Absolute flows of foreign direct investment (FDI) might increase significantly in some countries, but the developing countries' share of total world FDI flows will probably remain relatively low (about 15 percent) largely because FDI in the United States will continue at high levels. To attract more foreign direct investment, developing countries must maintain both favorable macroeconomic policies and a climate favorable to FDI.

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This paper — a product of the Debt and International Finance Division Division, International Economics Department — is part of a larger effort in PRE to assess the potential for increasing foreign direct investment in support of economic development. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Sheilah King-Watson, room S8-045, extension 31047 (58 pages).

Drawing on the findings in 11 country studies, Brewer concludes that the public policy environment for foreign direct investment (FDI) has improved in recent years. There is more appreciation of FDI's contributions (such as the transfer of technology and managerial skills, the development of export markets, and the stimulation of local entrepreneurship, competition, and innovation) and greater appreciation of the role of the private sector and private investment in development.

But to improve the flow of FDI into development, more is needed — especially changes in policies toward FDI and changes in macroeconomic policies and conditions.

Positive policy shifts have improved the climate for FDI in Korea, Mexico, and Nigeria. Continuing restrictions limit FDI flows to India, Brazil, and some of the largest developing countries. Macroeconomic conditions and policies will continue to affect FDI flows and to dominate investors' decisions, as recent experiences in Mexico and Brazil indicate.

Policy reform designed to attract investors will be only marginally effective unless accompanied by appropriate macroeconomic policies. Marginal, isolated policy changes are not enough. Investors risk estimates are highly sensitive to perceptions of change and uncertainty.

Developed countries' guarantee programs to protect their own investors against noncommercial risks associated with FDI projects in developing countries — together with other developed country promotional activities — are an important part of the policy framework that affects FDI in developing countries.

Total FDI flows to developing countries are unlikely to rise significantly in the next few years. Average flows of about SDR15 billion a year (or 1 percent of developing countries' GDP) are likely for the next three years.

Absolute flows of FDI might increase significantly in some countries but the developing countries' share of total world FDI flows will probably remain relatively low (about 15 percent) largely because FDI in the United States will continue at high levels.

This paper was completed under the supervision of Kwang W. Jun. The background paper for this report is available on request. The background volume reviewed FDI experiences of 11 developing countries in three regions: Argentina, Brazil, Colombia, and Mexico in Latin America; India, Indonesia, Malaysia, Korea, and Thailand in Asia; and Kenya and Nigeria in Africa. The main author of the background paper was Gyorgy Becsky. Other contributors were Young-Hoi Lee and Aloysius Ordu.

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(The paper was completed, under the direction of Kwang W. Jun, in April 1991)

Chapter 1

Introduction

The low level of foreign direct investment (FDI) in developing countries during portions of the 1980s, in combination with the increased burden of servicing their external debt, has prompted renewed interest in ways to facilitate FDI. This renewed interest has been reflected in more favorable policies toward FDI in the host countries and in the initiatives of international institutions. This increased activity has created a need for readily available information concerning patterns in FDI in developing countries, host country policies, and other conditions that affect investment.

Purpose and Scope of the Study

This study provides a summary of patterns, policies, and prospects concerning FDI in developing countries. The focus of the study is on host country policies, but the policies of home governments and international institutions also are analyzed. The study concludes with a projection of the prospects for FDI flows to developing countries. It provides a wide-ranging treatment that is intended to serve as a basis for discussions about a variety of issues related to FDI.[1]

The emphasis of the study is on the factors that affect the patterns and trends of FDI in developing countries. Implicit to the study is the theme that FDI can make significant contributions to the long-term development process and that policy reforms that contribute to greater FDI are consequently desirable. The roles of the private sector in the development process, and the contributions of private FDI in particular have long been debated. It is, nevertheless, useful to review briefly the case in favor of fostering an even greater role for FDI in the long-term development process because much recent discussion about FDI has been slanted toward relieving the external debt burden of developing countries, especially in the short term. Relief, however, has its price in the higher yields on FDI compared with interest on loans (Caprio, Gelb, and Johnson 1989). The recipient countries also face the risk that if the investors repatriate capital, funds will be lost when most needed; if the recipients prohibit repatriation, they will lose their creditability.

Whatever its contribution to short-term debt relief may be, FDI can be understood and appreciated as a package of resources that complements other financial flows to developing countries and makes a distinctive contribution in the development process. Indeed, it is precisely the nonfinancial components of the direct investment package and their long-term effects that are often the most important in the development process.

FDI projects typically involve a transfer of technology and managerial skills from the source country to the recipient country. Although the extent, form, and appropriateness of the technology are often at issue in individual projects, there is no doubt that in the aggregate FDI is an important channel for transferring technology and managerial skills to developing countries.

FDI projects also can provide greater access to world markets for host-country exports. Because of their ties to parent corporations in the home country and other affiliated corporations in third-country markets, FDI projects in developing countries facilitate market penetration and market expansion in countries where they have corporate connections. Further benefits in the economy of the host country can occur as the result of the stimulus FDI often gives to local entrepreneurs, competitors, and innovators. The entry of a foreign firm using different components or assembly techniques, for example, can have such effects.

In addition to these benefits of FDI are the usual employment and income-generating effects of an investment--whether undertaken by a domestic or foreign firm--and the immediate or long-term balance of payments effects of the associated international financial flows. There are, of course, social costs as well as benefits associated with FDI projects. For instance, FDI can have adverse effects in a highly protected environment, by leading to high cost production. There are, moreover, important issues about the distribution of the costs and benefits within and between the host and home countries. Although these additional considerations can mitigate and complicate the net beneficial effects of FDI in the host country, they do not alter the contribution that FDI can make in the long-term development process. There is therefore a need for countries to adopt policies that are more conducive to FDI so that its role in the development process can be expanded.

The analysis of FDI presented here is based in substantial part on the country studies that appear in Foreign Direct Investment in Selected Developing Countries in the Last Two Decades by Gyorgy Becsky, Young-Hoi Lee, and Aloysius Ordu. Those recently completed studies concern FDI in eleven countries: Argentina, Brazil, Colombia, and Mexico in Latin America; India, Indonesia, Malaysia, Republic of Korea, and Thailand in Asia; and Nigeria and Kenya in Africa. Those countries were selected for their geographic, economic, and policy diversity; they include both oil exporters and oil importers. Some of the countries have adopted relatively restrictive policies toward FDI, while others have been more open, especially in recent years. Most of them are major FDI recipients, and many are newly industrialized countries with substantial exports of manufactured goods. They have collectively been the recipients of approximately half of the FDI flows to all developing countries during the past decade. In total, these eleven countries provide a useful sample for the study of FDI.

Data Issues

Foreign direct investment is a long-term investment that can include new equity investments, reinvested earnings, and related lending. Any given investment can involve establishing, acquiring, or expanding an affiliated subsidiary corporation or branch. An essential element of a direct investment (contrasted with a portfolio investment) is a continuing substantial interest in, and an effective voice in, managing the real assets of a foreign affiliated entity. An ownership share of at least 10 to 25 percent is commonly considered the minimum threshold for an investment to be considered a direct investment, but the essential ingredient is control over assets. Where there is no substantial influence in the management of the foreign enterprise, the investment is

considered a portfolio equity investment.[2]

There are numerous sources of data on FDI, and no single source is by itself necessarily adequate for a given purpose. For the most part, this study uses data on FDI flows reported by the International Monetary Fund's (IMF) Balance of Payments Statistics Yearbook and International Financial Statistics. The IMF's data on FDI have several virtues: they provide relatively comprehensive country coverage, extend over many years, are based on a broad notion of FDI, and facilitate cross-national comparisons. In preparing these two volumes, IMF data have been supplemented by data from the Organization for Economic Co-operation and Development (OECD), the United Nations Centre on Transnational Corporations (UNCTC), national governments, and other organizations and individuals.

One important difference between this paper and earlier World Bank Staff Working Papers on FDI is the principal source of FDI data that has been used.[3] Whereas the present paper relies primarily on IMF data, the previous papers relied extensively on OECD data. Thus, any comparisons between data in those papers and the present volume should be made with considerable caution; this is particularly true with regard to time series analyses that extend back in time prior to 1975.[4] Appendix 1 of this report provides an in-depth comparison between alternative sources of FDI data.

Despite these data issues, basic patterns and trends can be discerned for the developing countries as a whole (see chapter 2) and for the eleven selected countries (see chapter 3). Following these descriptions of the central tendencies and variations in the basic data, subsequent chapters consider the variables that influence these patterns and trends. Chapter 4 considers the host country economic and political environment, chapter 5 considers host country FDI policies, and chapter 6 considers the policies of home governments and international institutions. Chapter 7 concludes the study with an analysis of the prospects for the future of FDI in each of the eleven selected countries, as well as for all developing countries collectively.

Chapter 2

Overall Patterns and Trends

From the 1950s until the mid-1960s, net FDI flows to developing countries remained at relatively low levels of $2 billion dollars or less a year. During this period there was substantial disinvestment--some voluntary, some forced--in petroleum, mining, agriculture, and manufacturing. Beginning in the late 1960s annual net flows increased until they reached a peak in 1981 of $15.3 billion, or about one-half percent of the developing countries' GDP. These increased flows of FDI were responses to the combination of economic growth and industrialization in several large developing countries, more hospitable policies in some of the host countries, and more flexible policies on the part of investors.

The four-year period from 1983 through 1986 was marked by lower levels of annual flows of $10.2 billion to $11.2 billion (SDR9.7 billion to SDR9.2 billion). In the latter part of the decade, however, there was a modest reversal, with annual flows exceeding $15 billion (see table 2-1 for additional details on the absolute magnitudes of the flows).

Table 2-1: Absolute Magnitudes of FDI Flows to All Developing Countries, 1975-88

Year	SDRs	Current U.S. dollars	Constant U.S. dollars
1975	5.4	6.3	10.0
1976	4.1	4.8	7.6
1977	5.5	6.7	7.4
1978	6.1	8.0	9.9
1979	7.9	10.3	11.3
1980	8.6	10.9	10.9
1981	13.1	15.3	15.2
1982	12.3	13.6	13.8
1983	9.7	10.2	10.5
1984	10.3	10.1	10.7
1985	11.6	12.7	13.4
1986	9.2	11.2	10.0
1987	11.4	16.7	13.6
1988[a]	13.7	18.5	13.9

a. Preliminary figures.

Source: IMF

Shifts in the relative importance of FDI in the total flow of financial resources to the developing countries are apparent in table 2-2. Although FDI flows were only 12.8 percent of the total net flow of financial resources in 1980, they had increased to 20.9 percent in 1986, and according to preliminary figures, to 33.4 percent in 1987. This reflects the slowdown in bank lending to developing countries. In table 2-2 it is also apparent that FDI flows to developing countries have declined considerably as a percentage of total world FDI --from 29.5 percent in 1975, to 23.8 percent in 1980 and to 13.7 percent in 1988. The counterpart to this decline was a large increase in FDI in the industrial countries, especially the United States. The amount of FDI in relation to the recipient developing countries' economies declined until 1986 after peaking in 1981-82.

Table 2-2. Relative Magnitudes of FDI Flows to All Developing Countries, 1975-1988
(percentage)

Year	Total World FDI flows	Net flow of Financial resources to developing countries	GDP of developing countries	Gross domestic investment in developiong countries
1975	29.5	15.0	0.8	3.0
1976	27.3	10.8	0.5	2.1
1977	25.7	12.2	0.5	1.8
1978	24.0	12.2	0.5	1.8
1979	24.8	13.6	0.5	2.0
1980	23.8	12.8	0.5	1.8
1981	24.6	14.6	0.6	2.3
1982	25.5	14.7	0.6	2.2
1983	21.7	13.7	0.4	1.8
1984	20.0	15.3	0.5	1.8
1985	24.9	20.2	0.5	2.2
1986	14.6	20.9	0.5	2.1
1987	14.3	33.4	0.7	2.9
1988[a]	13.7	--	0.7	2.7

-- Not available
a. Estimated figures.

Source: IMF

In table 2-3 it is evident that the proportions of the principal components of FDI--new equity, reinvested earnings, and FDI-related borrowing--have also shifted over time. The new equity component had thus increased to over 65 percent of total FDI flows to developing countries by 1988--up from 23 percent in 1977 and 46 percent in 1982.[9] Meanwhile, the proportions for both reinvested earnings and FDI-related borrowing had decreased. In 1988 reinvested earnings were 9 percent and borrowing 25 percent of the total flows. There were important individual country exceptions to these trends, however. For instance, although the relative importance of reinvested earnings in Brazil exhibits substantial year-to-year fluctuations, there has not been the same downward trend over the past decade that the worldwide data reveal.

Table 2-3: Components of FDI Flows to Developing Countries, 1975-88
(percent)

Year	Equity	Reinvested earnings	Long-term borrowing	Short-term borrowing
1975	27.1	18.3	54.4	0.2
1976	12.9	30.4	59.3	-2.6
1977	23.4	28.1	50.2	-1.6
1978	36.9	29.5	34.5	-0.9
1979	42.0	23.1	39.0	-4.2
1980	52.5	24.7	23.6	-0.8
1981	46.3	19.7	34.6	-0.6
1982	45.5	22.6	30.7	1.2
1983	44.0	15.8	40.9	-0.7
1984	57.5	14.2	26.0	2.3
1985	53.6	17.4	33.3	-4.3
1986	54.3	20.0	26.0	-0.6
1987	62.0	14.5	23.1	0.4
1988	66.7	9.1	24.2	0.4

Note: These are net figures, for example, new equity less divestment. See IMF (1977), p.140, para. 419-20.

Source: IMF.

Host Countries and Regions

FDI in the developing world has consistently been concentrated in a small number of individual countries. This was true in an earlier era, when investments in the primary sector predominated, and it has also been true in recent years, when manufacturing investments have been more common. Thus, a few economically large or upper-middle-income countries in Latin America and Asia have been the principal recipients, and the regional distributions generally reflect these country concentration patterns.

Table 2-4 lists the estimated regional distributions of FDI stocks. In 1960 one-half of the FDI stock in developing countries was in Latin America, with slightly less than one-fourth in Asia. During the 1960s the share in Latin America increased and the share in Asia decreased, while other regions' shares did not change significantly. Then, during the 1970s, the Asian share increased, while the Latin American and African shares decreased--trends that continued in the 1980s.

Table 2-4. FDI Stocks by Region of Host Developing Countries, Selected Years
(percent of all developing countries)

Region	1960	1971	1980
Latin America	48.3	57.6	53.1
Africa	17.0	17.1	10.6
Asia	23.3	15.2	25.8
Middle East	8.5	6.8	3.5
Europe	2.8	3.3	7.1

Source: Stopford and Dunning (1983), as reported in OECD (1987), table 3-2, p.187.

In table 2-5, where yearly flows are given, the increased share going to Asian countries is apparent. By 1985-86 one-third of all FDI flows to developing countries was going to Asian countries. Among Latin American countries, Colombia has been an exception to the general decline in FDI during the 1980s. After several years of declining investor interest in the early 1980s, FDI in Mexico increased substantially in the late 1980s. Overall, however, by 1986 the Latin American countries' share of FDI flows had declined to 24.6 percent.

Table 2-5. Foreign Direct Investment Flows Region of Host Developing Countries, 1981-87 (percent of all developing countries)

Region	1981	1982	1983	1984	1985	1986	1987
Latin America	35.5	24.5	21.2	20.4	31.6	24.6	46.4
Africa	7.0	6.9	7.2	6.7	6.4	5.6	5.6
Asia	22.1	17.6	31.0	28.8	37.6	32.8	51.6
Middle East	31.3	48.1	35.8	38.5	17.3	30.8	-13.8
Europe	4.4	3.0	5.5	5.7	6.8	6.2	10.3

Source: IMF.

Until 1989, FDI in China had been increasing substantially--from SDR389 million in 1982 to SDR1,598 million in 1986 (Pfeffermann 1988). Elsewhere in Asia, FDI flows have also increased--in recent years the Republic of Korea, and in earlier years to Malaysia, Singapore, and Indonesia have received increased shares. As noted in the section entitled "Sectoral Shares," the geographic distribution trends for FDI are affected by the large amounts of FDI in off-shore banking centers and in flags-of-convenience shipping.

Source Countries

There has been a high degree of concentration in FDI flows by source country (table 2-6). Five countries--the United States, United Kingdom, Federal Republic of Germany, France, and Japan--have accounted for 80 percent or more of the total FDI flows to developing countries. The U.S. share had been around 40-60 percent in the late 1970s, but declined in the 1980s. In contrast, Japan's share rose from 10.9 percent in 1975 to 37.2 percent in 1987. The three European countries' individual and collective shares have fluctuated from year to year, but exhibited no strong trends over the 1975-87 period.

Table 2-6. Home Country Shares of FDI Flows to Developing Countries, 1975-87
(percent)

Year	United States	United Kingdom	Fed. Rep. of Germany	France	Japan	Total
1975	63.8	5.8	7.2	2.4	10.9	90.0
1976	37.4	10.0	9.2	2.9	22.3	81.9
1977	49.4	12.0	8.6	2.7	11.6	84.3
1978	48.0	7.0	8.8	3.5	17.3	84.7
1979	60.5	5.2	6.2	5.1	10.4	87.3
1980	30.9	17.6	14.5	8.3	15.4	86.6
1981	38.4	13.8	8.0	6.7	23.3	90.3
1982	44.1	10.5	8.0	7.6	18.9	89.1
1983	25.6	16.2	9.2	4.4	19.4	74.8
1984	39.7	18.9	6.3	2.4	15.6	82.9
1985	14.4	32.6	-2.2	9.0	15.5	69.2
1986	27.9	17.1	3.7	5.5	27.8	82.0
1987	40.3	9.5	3.4	3.5	37.2	93.8

Note: All percentages are of outflows from OECD countries only, not world totals.

Source: OECD.

Another development in the past decade has been an increase in FDI flows from developing countries. Multinational firms from Brazil, for instance, have undertaken investments in the countries of West Africa and in other developing areas. Meanwhile, Brazil has received investments by 1985 from such developing economies as Kuwait, Saudi Arabia, South Africa, Iran, Portugal, and Hong Kong--although they totalled less than 2 percent of Brazil's the FDI stock.

Malaysia, Singapore, and Hong Kong are unusual among developing economies in the extent to which they are both recipients of and sources of FDI, which reflects the intense activity in intraregional FDI in Southeast Asia.[10] Malaysia is especially prominent for the high proportion of FDI that has come from other developing countries as of 1983, 44 percent of its FDI stock in "pioneer industries" was from non-OECD countries, including 33 percent from Singapore. Five Asian developing countries exhibit relatively high proportions of FDI stocks from other developing countries: Thailand, 17.6 percent in 1984; India, 13.2 percent in 1974; Indonesia, at least 9.6 percent in 1983; and the Republic of Korea, close to 9 percent in 1986. In three of the Latin American countries, the comparable figures were generally less than 5 percent. (There are no directly comparable data for Argentina, Nigeria, or Kenya.) Table 2-7 lists additional data on FDI; those data indicate FDI flows from developing countries were usually about 1.5 percent of world totals. Three-fourths of the outflows were from Latin American countries.[11]

Table 2-7. FDI Flows from Developing Countries, 1975-87

Year	SDRs (millions)	Percent of total world FDI
1975	181	1.0
1976	313	2.1
1977	310	1.4
1978	299	1.2
1979	332	1.0
1980	485	1.3
1981	325	0.6
1982	1,057	2.2
1983	721	1.6
1984	448	0.9
1985	1,101	2.4
1986	938	1.5
1987	1,223	1.5
1988	1,159	1.2

Source: IMF.

It should also be noted that the centrally planned economy and Council for Mutual Economic Assistance (CPE-COMECON) countries of Eastern Europe are source countries of FDI in developing countries--although at relatively modest levels (McMillan 1987, pp.33-46). In 1983 there were at least 213 COMECON FDI projects in 75 developing countries, including Mexico, India, and Nigeria, with a disproportionate number in Africa. The total stock of these investments, however, has been estimated at only $1 billion to $2 billion (out of a worldwide total COMECON FDI stock of approximately $4 billion to $6 billion in 1983) (McMillan 1987, p.40). This compares with a total FDI stock in all developing countries from all sources of approximately $200 billion.[11]

In addition to the FDI from the state enterprises of the COMECON countries, there is also outward FDI by the state economic enterprises (SEEs) of developed and developing countries. Unfortunately, the readily available data on FDI flows and stocks do not separate the portion of FDI from SEEs in the developed or developing countries, but the share of FDI in developing countries controlled by home country SEEs is low.

Sectoral Shares

A sectoral analysis of the shares of FDI must be qualified by the data's limitations. Nevertheless, some patterns and trends can be observed in the data presented in tables 2-7 and 2-8. Although these data do not extend back far into the past, it is well known that FDI in manufacturing began to increase in importance compared with the earlier emphasis on FDI in the primary sector before the 1970s (table 2-8).[13]

Table 2-8. Sectoral Shares of FDI Stock in All Developing Countries, Selected Years
(percent)

Sector	1971	1975	1978	1982
Extractive	22.9	26.7	12.8	22.6
Manufacturing	59.0	53.2	64.5	54.1
Services	18.1	20.1	22.7	23.3

Source: Dunning and Cantwell, (1987), table B2, p. 793, and table B3, p.795 for 1975 and 1982 respectively; Stopford and Dunning (1983), as reported in OECD, International Investment and Multinational Enterprises (1987) table 3-12 on p. 197, for 1971 and 1978.

Within the manufacturing sector there was an important shift that is not revealed by the data in those tables but that has been frequently noted (see, for example, OECD 1987, pp. 38-40). Manufacturing FDI was strongly oriented toward import substitution projects for rapidly growing markets, especially in Latin America, until the 1970s. Starting in the 1970s and continuing into the 1980s, however, the emphasis in manufacturing FDI shifted to low production cost, export-oriented projects. This shift in corporations' strategic emphasis within manufacturing goes hand-in-hand with the regional shift noted above--the decreasing proportions of FDI in Latin America and the increasing amount in Asia.

At the same time, the share of FDI in services increased from 20.1 percent in 1975 to 23.3 percent in 1982. This increase in the share of FDI in services, is highly concentrated in the financial services industry, especially in offshore centers.

Several of these patterns and trends are evident in some detail in table 2-9, where increases in U.S. and Japanese direct investments are broken down by sector and by region. The large increases in FDI in services by both the United States and Japan, for instance, can be noted--as can the large amounts of U.S. investment in offshore financial centers.

Table 2-9. Increases in Outward FDI Stock from the United States and Japan by Sector and Region, 1977-85 (US$ billions, increase from 1977 to 1985)

	Latin America	Offshore Centers[a]	Asia[b]	Africa	Middle East	All developing countries
UNITED STATES						
Primary[c]	2.3	0.6	4.3	2.7	7.1	17.1
Manufacturing	5.3	0.4	2.0	0.1	0.3	8.2
Services[d]	1.7	12.7	3.1	0.1	1.0	17.8
Banking	0.4	3.8	0.9	0.2	0.2	5.4
Financial insurance real estate	0.8	8.5	0.6	-0.1	-0.1	9.8
Wholesale trading	0.3	0.5	1.3	0.0	0.5	2.6
All industries	9.3	13.7	9.4	2.9	8.4	43.1
JAPAN						
Primary[c]	1.0	n.a.	4.8	0.2	0.2	5.2
Manufacturing	2.5	n.a.	5.5	0.1	0.8	8.5
Services[d]	8.3	n.a.	5.5	2.1	-0.2	14.3
Financial and insurance	1.5	n.a.	0.9	0.0	0.1	2.1
Real estate	0.0	n.a.	0.4	0.0	-0.4	-0.1
Trading	0.8	n.a.	1.4	0.0	0.0	1.7
All industries	11.9	n.a.	16.0	2.5	1.5	28.9

n.a. Not available.

a. Bahamas, Bermuda, Panama, Trinidad and Tobago, and other Caribbean islands.
b. Asia and Pacific for United States, Asia plus Oceana for Japan.

c. Includes petroleum, mining, forestry, agriculture and fishing. For U.S. figures for Latin America and offshore centers, one-half of the "other industries" plus "other services" sum has been allocated to the primary sector.

d. Services totals do not equal sums of the subtotals for the more refined industry grouping because some subtotals have been omitted. The services totals were computed by subtracting the primary and manufactuing sectors from the overall totals for the United States in order to correct for its contamination by some primary-sector projects in the source tables.

Source: United Nations Centre on Transnational Corporations (1988), annex tables C-1 and C-2, p. 589. Some lines in the source tables have been aggregated and others deleted to simplify the present presentation.

Chapter 3

Patterns and Trends in Eleven Host Countries

The eleven countries selected for the studies in Becsky, Lee, and Ordu (1990) include many of the principal FDI host countries, including Brazil, Malaysia, and Mexico. Collectively, these eleven countries accounted for more than half of the FDI inflows into all developing countries in each of the years from 1975 through 1983; from 1984 through 1988 they accounted for nearly one-half, as indicated in table 3-1.

Table 3-1. Eleven Host Countries' Shares of FDI Flows to All Developing Countries, 1975-88
(percent)

Country	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Argentina	n.a.	n.a.	2.2	3.2	1.9	6.1	5.4	1.7	1.8	2.6	7.5	5.3	-0.1	6.2
Brazil	21.0	32.6	28.1	25.7	22.7	17.1	16.5	22.1	15.2	15.8	11.2	3.0	8.0	0.0
Colombia	0.6	0.5	1.0	1.4	1.2	1.4	1.7	2.8	6.0	5.8	8.4	6.2	2.1	1.2
Mexico	9.8	13.2	8.5	10.7	12.5	19.2	18.6	12.4	4.4	3.9	4.1	14.0	21.1	14.0
India	1.6	1.2	-0.7	0.3	0.6	0.9	0.7	0.6	0.1	0.2	0.9	1.3	1.3	1.3
Indonesia	7.7	7.2	3.7	3.6	2.1	1.6	0.9	1.7	2.8	2.2	2.5	2.4	2.9	2.9
Korea, Rep. of	0.9	1.7	1.4	1.2	0.3	0.1	0.7	0.5	0.7	1.1	2.0	3.9	3.9	4.7
Malaysia	5.7	8.0	6.2	6.4	5.4	8.3	8.3	10.6	12.3	7.9	5.7	4.5	2.8	3.5
Thailand	0.4	1.7	1.6	0.7	0.5	1.7	1.9	1.5	3.4	4.0	1.3	2.4	2.3	6.0
Kenya	0.3	1.0	0.9	0.4	0.8	0.7	0.1	0.1	0.2	0.1	0.1	0.3	0.4	0.1
Nigeria	6.7	7.1	6.8	2.7	2.9	-6.6	3.6	3.2	3.4	1.9	3.9	1.8	3.9	4.5
TOTAL	52.9	72.9	60.3	56.1	50.4	49.5	57.7	56.6	50.3	45.2	46.6	44.0	47.3	43.2

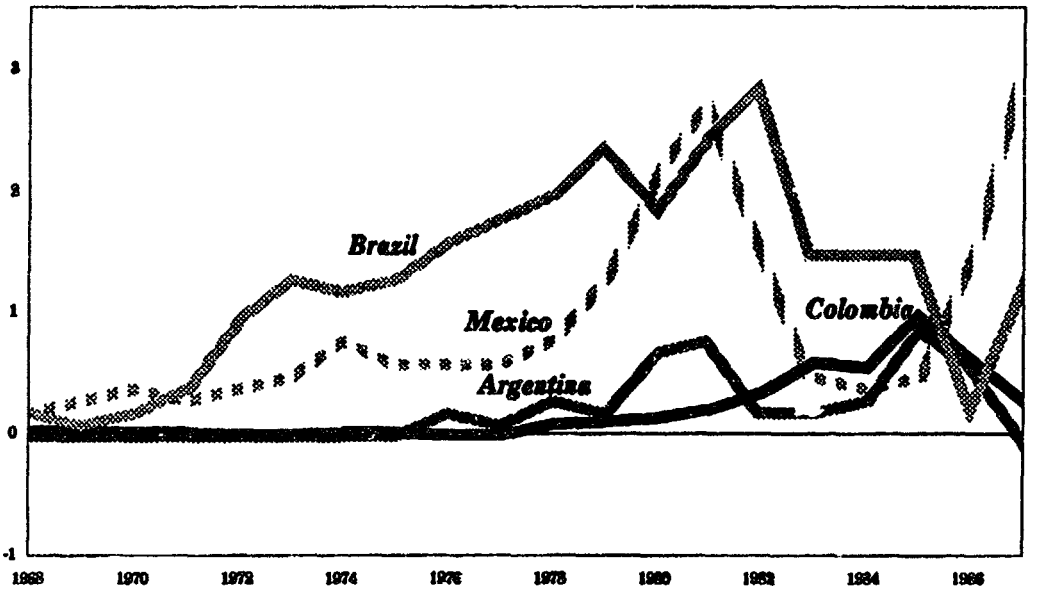
n.a. not available
Source: IMF.

The patterns and trends in FDI in these eleven countries inevitably reflect the same dynamics at the global and regional levels, but the differences in the patterns and trends in FDI among the countries are at least as striking as the similarities. Indeed, the relative independence of FDI flows among these eleven countries is apparent in weak correlations in FDI flows for each pair of countries; even the intra-regional country-pair correlations are generally weak. Neither at the global level nor within regions do FDI flows to developing countries fluctuate in synchrony; rather, each host country's experience is relatively autonomous.

Individual Country Trends

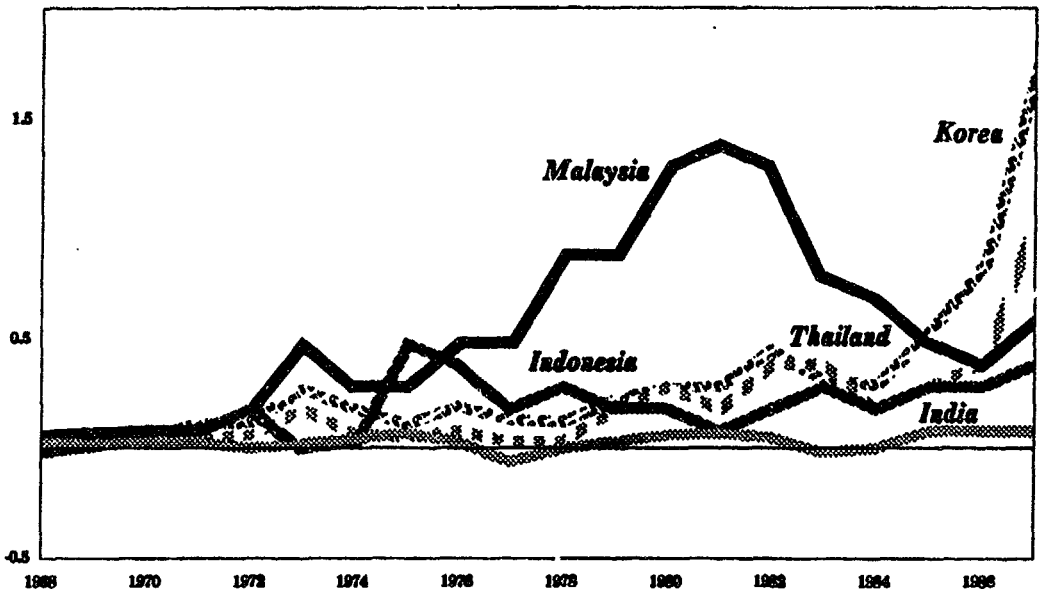
Time series data in constant U.S. dollars for FDI flows to the eleven countries are displayed in charts 3-1 to 3-3.[14] Among the eleven countries, Brazil is unique in the pattern of substantial increases into the early 1970s, relatively high levels into the early-1980s, and precipitous decreases since the early 1980s. In the other Latin American countries the large fluctuations in the early and mid-1980s are the most obvious similarity across the selected countries. In Colombia the surge of FDI in the early to mid-1980s is conspicuous among the eleven countries in the degree of its deviation from an otherwise stable and relatively low-level pattern over the two decades from the late 1960s to the late 1980s. Average annual flows were greater at the end of the period than at the beginning for Argentina, Colombia, and Mexico; nevertheless, the year-to-year fluctuations around the relatively high levels in the 1980s were so great compared with the earlier years that one cannot be confident about any generalized description of a long-term trend.

Chart 3-1. FDI Flows in Four Latin American Countries (in US$ billions)



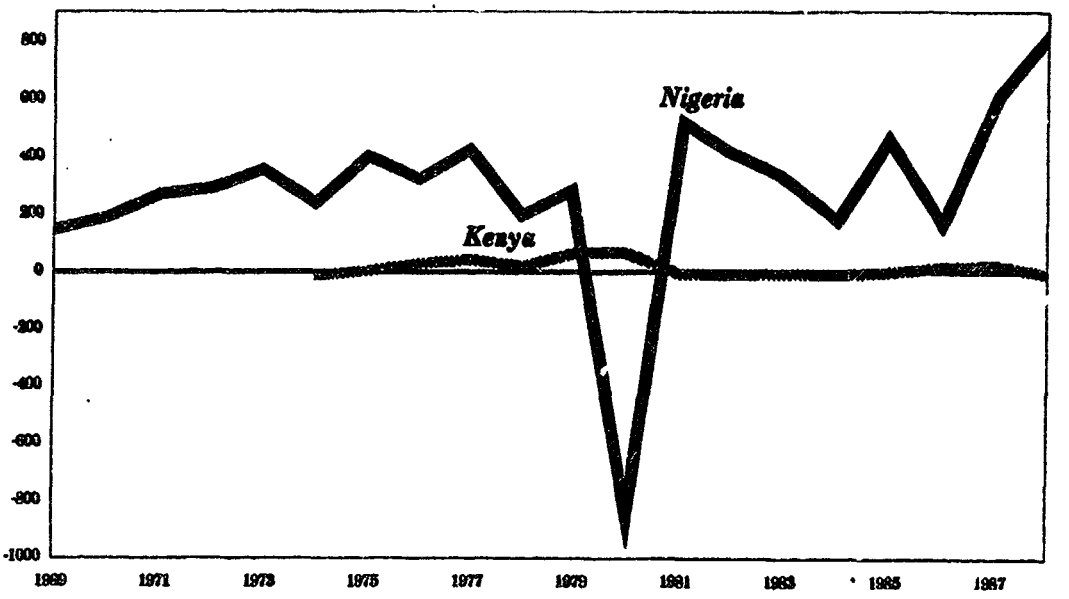
Among the five Asian countries over the twenty-year period, there was a general trend of increasing flows, but there were significant positive and negative deviations from this basic trend in each country. Furthermore, each country graph reveals a distinctive profile over time. Except for a large dip in 1973-74, Indonesia experienced increasing flows from the late 1960s to the mid-1970s, and relative stability since. India experienced overall low levels throughout the period. FDI flows into Korea were relatively stable at low levels but then increased over the 1984-87 period. Malaysia and Thailand both experienced relatively large magnitudes of inflows in 1974 and again in the early 1980s (1982 was a peak year for Malaysia and 1984 for Thailand).

Chart 3-2. FDI Flows in Five Asian Countries
(in US$ billions)



Reflecting the record of other African countries, Kenya and Nigeria were experiencing lower levels of FDI inflows (in constant dollars) at the end of the 1980s than at the beginning; the basic trend for Nigeria has been one of decline for the two-decade period, while Kenya experienced a positive though moderate inflow throughout the period. Whereas Kenya's inflows reveal no volatility, Nigeria experienced a large but brief negative deviation in 1980.[15]

Chart 3-3. FDI Flows in Two African Countries
(in US$ millions)



Summary data on the long-term trends and year-to-year fluctuations in those trends are presented in table 3-2, based on linear regressions for each of the eleven countries. The differences across the countries in the long-term trends, as indicated by the slope coefficients, are apparent. Argentina, Colombia, and Malaysia experienced annual increases (indicated by the slope) exceeding 10 percent of their mean FDI flows for the period, but the comparable figures for the other countries were quite low. Even more pronounced, however, is the degree of departure from the trend of the annual flows to individual countries, as indicated by the (small) R-squares.

Table 3-2. Time-Series Regressions of FDI Flows for Eleven Host Countries, 1968-87

Country	Slope coefficient (b)[a]	Coefficient of determination (R^2)	Slope as percent average FDI
Argentina	+0.029	.31	11.6
Brazil	+0.002	.00	0.1
Colombia	+0.030	.41	12.5
Mexico	+0.044	.14	3.7
India	+0.001	.01	1.0
Indonesia	+0.003	.01	1.2
Korea, Rep. of	+0.004	.05	3.6
Malaysia	+0.037	.35	17.3
Thailand	+0.006	.13	3.3
Kenya	-0.001	.04	-3.3
Nigeria	-0.029	.26	-6.9

a. Billions of constant 1980 U.S. dollars a year.

Sectoral Concentration

The eleven host countries also vary in the degree of concentration within sectors (table 3-4). Brazil and Mexico are notable for their high proportions (three-fourths) of FDI in the secondary sector, and Indonesia and Colombia are notable for having 60 percent or more of their FDI in the primary sector, mostly in oil and gas. Korea, Malaysia, and Nigeria stand out for their relatively large proportion of FDI in services. By 1986, 40.2 percent of Korea's FDI stock was in the tertiary sector--including 27.4 percent in hotels (in anticipation of the Olympic games in 1988) and 7.1 percent in banking and finance (following liberalization of banking regulations); furthermore, FDI in insurance is expected to increase as a result of liberalization of restrictions on FDI in that industry.

Malaysia and Nigeria, exhibit an unusual degree of diversification, with substantial proportions of their FDI stock in each of the sectors. Such a diversification of FDI across sectors is advantageous to a given host country because it mitigates cyclical fluctuations associated with individual sectors, especially the primary sector.

Table 3-3. Sectoral Distribution of FDI Stocks in Eleven Host Countries
(percent of total)

Country	Primary	Secondary	Tertiary	Year[a]
Argentina	27.4	48.3	23.3[b]	1976-83
Brazil	13.5	74.7	19.2	1985
Colombia	61.0[c]	29.0[c]	10.0[c]	1985
Mexico[d]	n.a.	76.0	n.a.	1984
India	15.8	55.2	29.0	1974
Indonesia[e]	62.5	n.a.	n.a.	1983
Korea, Rep. of	0.7	59.2	40.2	1986
Malaysia	26.9	33.5	39.0[b]	1972-81
Thailand[f]	n.a.	33.0[c]	n.a.	1984
Kenya	3.1	64.3	32.6[b]	1985
Nigeria	28.4	30.1	41.5[b]	1986

n.a. Not Available.

Note: Figures do not add to 100.0 for some countries because of unclassified projects, imprecise estimates, or rounding.

a. Latest year available in Becsky, Lee, and Ordu (1990). Where multiple years are shown, the stocks are based on the cumulative flows for the indicated years only.

b. Estimates computed from figures for other sectors or computed from estimates in original source.

c. Rounded estimates in Becsky, Lee, and Ordu (1990).

d. The 76 percent figure for Mexico is based on the country study estimate of 74-77 percent depending on the year. The latest year for the sectoral distribution is 1984.

e. The Indonesia country study estimates "nearly 10 billion" in energy out of a total of "nearly 16 billion".

f. The Thailand country study estimates "one-third" in manufacturing.

Source: Becsky, Lee, and Ordu (1990), tables 2-6, 3-5, 4-3, 5-22, 6-9, 7-4, and 7-7.

Source Country Concentration

Over time, as FDI accumulates, a single source country may come to dominate the stock of FDI in a given recipient country. A relatively high degree of source-country concentration can create greater nationalistic sensitivities about FDI and vulnerability to shifts in the FDI policies of the home governments and corporations. Among the eleven countries, there is considerable variance in the source-country concentration ratios presented in table 3-5. Four of the host countries exhibit ratios of 60 percent or more: Kenya, where the British colonial legacy is still apparent; Colombia and Mexico, where the proximity to the United States is a factor; and Indonesia, where proximity to Japan is significant. The concentration ratios exceed 50 percent for two other countries--Nigeria (United Kingdom, 54.5 percent) and Korea (Japan, 54.9 percent).

Table 3-4. Source Country FDI Stock Concentration Ratios in Eleven Host Countries

Host country	Percent	Source Country	Year[a]
Argentina	39.7	U.S.	1976
Brazil	31.4	U.S.	1985
Colombia	67.0[b]	U.S.	1986
Mexico	66.0	U.S.	1984
Indonesia[c]	60.0	Japan	1983
Korea, Rep. of	54.9	Japan	1986
Malaysia	n.a.[c]	Singapore	1987
Thailand	30.2	U.S.	1984
Kenya	67.0	U.K	1972
Nigeria	54.5	U.K.	1986

n.a. Not available

a. Latest year available in Becsky, Lee, and Ordu (1990).

b. Rounded to nearest percent in original source.

c. Based on U.K. figure for 1987 (estimated) against total for 1984 in original table, Singapore's share would be greater than 18.5 percent.

d. Estimates from the country study for total FDI. Smaller estimates of 42.1 percent and 48.2 percent in Table 5.5 are for BKPM jurisdiction FDI projects only. Using data in Table 5.3, the figure would be 54.3 percent.

Source: Becsky, Lee, and Ordu (1990), tables 2-7, 3-6, 3-11, 3-15, 4-4, 5-7, 5-11, 6-4, 6-8, 7-5, and 7-11.

Chapter 4

Host Country Economic and Political Environment

Macroeconomic and political conditions are the most important host-country variables affecting investors' FDI decisions. Because host-country economic conditions affect FDI projects in the same way that they affect domestically owned projects, a broad range of host-country economic policies is pertinent to foreign direct investors' operations. Some policies, such as wage and price controls, have direct effects on FDI projects; other policies, such as monetary and fiscal policies, can have important indirect effects.

The eleven selected host countries have varied substantially in their approach to such economic policies and in their responses to external and internal shocks. Whereas some countries have been inclined to alter government policies in response to changing circumstances and to allow market forces to operate in the balance of payments adjustment process, others have pursued government policies that constrain the adjustment process, at least in the short term. Yet, whatever the vicissitudes of macroeconomic conditions and policies, one ever-present key determinant of FDI is host-country economic size.

Size of Economy

Numerous studies of FDI have found that aggregate national market size, as indicated by host country GNP or GDP, is related to variations across countries in the levels of FDI inflows (Scaperlanda and Mauer 1969; Kobrin 1976). Similarly, a pooled time-series, cross-sectional regression of FDI flows on GDP for the eleven selected countries over the 1968-87 period found them to be positively related (and statistically significant at the .001 level). The relationship of variations among countries in the level of FDI flows to host-country economic size is also demonstrated in table 4-1.

Real growth rates in GDP have been found to be correlates of FDI flows by some studies (Root and Ahmed 1978), furthermore, economic stability, as measured by the inflation rate, can be an important variable in the host-country economic environment. A pooled time-series, cross-sectional multiple regression of FDI flows on GDP, growth rates, and inflation rates for these eleven countries during 1968-87 period was therefore undertaken; it reveals an R-square of only 0.11. Furthermore, neither GDP growth rate nor inflation rate was significantly related to FDI flows at the .05 level (although, again, GDP was significantly related to FDI). The relationship of FDI to economic growth and price stability may therefore be more complex than previously thought and involve lags over time and differences across countries that are difficult to capture without more complex econometric models.

Table 4-1. GDP and FDI For Eleven Host Countries, 1978-87
(annual average)

	1980 U.S. dollars (billions)		Rank	
Country	FDI	GDP	FDI	GDP
Argentina	0.25	49.9	6	7
Brazil	1.67	191.4	1	1
Colombia	0.24	29.4	7	8
Mexico	1.19	160.7	2	3
India	0.07	167.2	10	2
Indonesia	0.85	65.7	3	5
Korea, Rep. of	0.12	57.6	9	6
Malaysia	0.64	21.1	4	10
Thailand	0.18	28.6	8	9
Kenya	0.03	6.1	11	11
Nigeria	0.42	84.0	5	4

Source: IFS; IMF data are not reported for India in Becsky, Lee, and Ordu (1990; table 4-2). Nevertheless, the OECD figures reported there and the IMF figures reported here are identical for thirteen of the eighteen years (1968-85) reported in table 4-2. For the eighteen year period, the IMF figures averaged 0.008 a year more than the OECD figures. Indonesia's figures are based on a composite of IMF and OECD figures for 1968-86; see table 5-3 Becsky, Lee, and Ordu (1990). Korea's figures are from the Finance Ministry for 1968-86; the 0.12 reported here compares with the IFS average of 0.11 for 1968-87. See table 6-6 in Becsky, Lee, and Ordu (1990).

In table 4-2 the ratios of FDI flows to GDP for each of the eleven countries are presented for each five-year period from 1968 to 1987. Although those numbers are inevitably small, they nevertheless indicate the extent of the deviation in FDI flows for individual countries and time periods from what would be expected on the basis of the economic size of the host country alone. Malaysia, at one extreme, and India, at the other, are notable for the extent to which their FDI-GDP ratios differ from the mean of 0.4 percent for the group over the twenty-year period. Malaysia's FDI inflows were consistently far above and India's far below what would be expected solely on the basis of their economic size. Many countries exhibit stability in the relative sizes of their ratios over time, but others experienced significant changes in their ratios over the twenty-year period. Kenya's and Nigeria's ratios, in particular, were both quite high for the 1968-72 period before declining, while Brazil's decreased and Colombia's increased significantly by the 1983-1987 period. The ratio for Korea was surprisingly low throughout the twenty-year period, as FDI increases barely kept pace with GDP growth. Following Japan's example, Korea discouraged FDI in manufacturing sector until the 1980s.

There are, of course, important factors in addition to host-country economic size that affect FDI flows. The balance of this chapter considers the role of additional economic factors and the general political environment of the host country as influences on FDI flows. The next chapter considers more specifically and narrowly the FDI policies of the host countries, and chapter 6 considers the policies of home governments and international institutions as they bear directly on FDI in developing countries.

Table 4-2. Ratio of FDI Flows to GDP for Eleven Host Countries (percent)

Country	1968-72	1973-77	1978-82	1983-87
Argentina	0.1	0.1	1.0	0.8
Brazil	1.0	1.3	1.0	0.4
Colombia	0.6	0.2	0.5	1.6
Mexico	0.8	0.7	0.9	0.5
India[a]	0.0	0.0	0.0	0.0
Indonesia	1.5	2.4	1.4	0.3
Korea	0.2	0.2	0.2	0.2
Malaysia	2.1	3.6	4.0	2.3
Thailand	0.9	0.7	0.5	0.6
Kenya	1.0	0.6	0.6	0.2
Nigeria	1.1	0.7	0.2	0.3

a. India varied between 0.01 and 0.04 percent.
Sources: See table 4-1.

Economic Policies

A broad spectrum of host-country economic policies is inevitably of concern to foreign direct investors. All of the usual domestic economic policies that affect businesspeople's calculations of expected returns and risk pertain, but foreign direct investors are also concerned about host countries' international economic policies. Perhaps above all else, investors desire as much stability in economic policy as is practicable, but they also want economic adjustment processes to be allowed to operate with minimal government intervention.

Thus, for instance, they want exchange rates and interest rates to be allowed to adjust to changing inflation rates. If exchange rates, in particular, are not allowed to reflect cross-national differences in inflation rates, foreign direct investors (as well as other businesses) are exposed to price distortions in their costs and revenues that can threaten their long-run competitive position. Although investors prefer stable exchange rates in the short run, they do not want exchange rates to be inflexible and insensitive to basic price and income forces in the long run.

Investors may enjoy the benefits of low subsidized interest rates for their own projects, but they want interest rates in general to reflect inflation rates, and thus be positive in real terms. Otherwise, low domestic investment rates and capital flight can contribute to a deteriorating domestic economy and balance of payments position.

In order to gain a more refined understanding of the effects of host-country economic conditions and policies on FDI, further distinctions about the different kinds of FDI projects need to be made. In both the manufacturing and services sectors, although market size is a function of national incomes, changes in the distribution of income among regions within a country and among other socioeconomic groups can also affect the attractiveness of a host country's market. A less unequally distributed national income, and thus an increasingly large middle-income group, for instance, or migration from rural to urban areas, can make a given market more attractive for some products.

For all manufacturing FDI projects--and especially those based on an efficiency-seeking strategy--the effects of host-country economic conditions on the firms' costs are a central concern for investors.[16] Thus, inflation rates, foreign exchange rates, wage rates, national savings and investment rates, and all other economic conditions that bear on a project's costs are potentially important. Policies leading to import protection and export promotion also matter for FDI. The host-country corporate tax level, for instance, was found to be significantly correlated with manufacturing FDI flows to forty-one developing countries during 1966-70 (Root and Ahmed 1978). In recent years cost considerations have become particularly important as firms have restructured and further diversified and integrated their production operations internationally in response to competitive pressures.

In service industries, particularly in the past, many FDI projects were undertaken by corporations that followed their home-country corporate manufacturing clients into developing countries. Thus, direct investments were made in financial services, accounting services, and consulting services so that corporations could better serve (and thus retain the business of) their corporate customers as these customers undertook their own FDI projects. To the extent that the business of the corporate clients of the service industries depends on host-country economic conditions, the service corporations' interests are also dependent (indirectly) on those same conditions. This indirect dependence of the service industries on host-country economic conditions will continue in the future because many service industry FDI projects are still primarily designed to serve home-country based corporate clients. In addition, however, many service industry FDI projects in the future will serve the local host-country market so that host-country economic conditions will become more directly relevant. The prevalence of this occurrence will depend on the extent to which the service sector is made more open to FDI through multilateral and bilateral negotiations.

For resource-seeking investments, of course, the host-country endowment in the relevant natural resource is the most important feature attracting investors, although even in those instances investors are not likely to be oblivious to economic conditions in the host country if there is more than one potential site for their extractive operations. As FDI in the primary mineral and agricultural sectors has declined in relative importance, and FDI in the manufacturing and services sectors has increased in relative importance, host country economic conditions have become more significant.

The precise effects of economic conditions, furthermore, greatly depend on the particular features of specific FDI projects. A project that imports a high proportion of its raw materials and components and exports a high proportion of its products will obviously experience a relatively strong and direct impact from changes in foreign exchange rates. A project that has a high proportion of its production costs in local labor and sells a high proportion of its products in the local market will be affected strongly by wage and price controls. In any case, the relationship between exchange rate changes and cross-national differentials in inflation rates can, of course, be crucial.

Economic conditions in neighboring countries can also be important--as the experience of Malaysia demonstrates. During the period from the late 1960s until the early 1980s, when FDI in Malaysia increased substantially, the economic growth in nearby Singapore and Hong Kong was a major driving force. By the mid-1980s, approximately half of the FDI in Malaysia had come from these two neighboring economies. In addition to the relatively rapid economic expansion in Singapore and Hong Kong that accounted for the FDI flows into Malaysia, however, the relatively low wage rates in Malaysia compared with the other two economies played an important role. This combination of growth in neighboring countries and low wages in Malaysia also accounts for many of the Japanese, British, and American investments in manufacturing. (In addition to the surge in manufacturing FDI in Malaysia, there have been Japanese and American investments in oil and liquefied natural gas in recent years, and there is a continuing British presence in agriculture.)

Political Stability

Investors' costs and revenues are not only affected by economic conditions, they are also dependent on political conditions, including the stability of the political system. Among the eleven selected countries, the effects of political instability on FDI can be demonstrated in two ways. First, and most important, there are countries such as Argentina, whose history has been marked by chronic political instability that deterred many investors from undertaking projects. Particularly in the case of Argentina, the changes in regimes (which have sometimes occurred through irregular means and have sometimes entailed major shifts in government ideology) have been accompanied by instability in FDI regulations and macroeconomic policy (Becsky, Lee, and Ordu 1990, Brewer 1986; Brewer 1985).

Second, brief periods of government instability can cause interruptions in FDI flows as investors "wait for the political dust to settle." For instance, in the late 1970s, Kenya, which is widely perceived as a relatively stable political environment for FDI, suffered a "hiatus of FDI that resulted from the death of Jomo Kenyatta [and] did not end until late 1979, following Arap Moi's election as president" (Becsky, Lee, and Ordu 1990, chapter 7). Even quite brief and transient interludes of instability can lead to cancellations of FDI projects, not merely their deferral, because investors sometimes react strongly to the slightest hint of instability (Brewer, David, and Lim 1985, p.217). A different kind of instability--civil war--led to declines in FDI in Nigeria in the 1960s.

Several studies have tried to determine empirically the role of instability in investors' decisions about FDI projects on the basis of systematically collected data. The studies have generally been of two kinds--those based on executives' answers to survey questions in interviews and questionnaires and those based on events and FDI data. The studies based on surveys consistently find that executives consider perceived host-country instability to be a major deterrent in FDI project location decisions (for example, Green 1972; Root 1968; Frank 1980, especially pp.111-12).

Other studies have also found significant effects of political instability on FDI flows. For instance, a study of foreign direct investments in manufacturing in twenty-four countries, including eleven developing countries, over the period from 1954 to 1975 by multinational corporations based in the United States was conducted to determine the relationship between FDI and political conflict (Nigh 1985). For the developing countries in particular, the study found that FDI flows were related to indicators of internal conflict such as riots and civil war; this was true for lags of zero to two years.

To the extent that political instability affects investors' perceptions of host-country conditions, and thus increases their uncertainties about the future environment for FDI, political instability can be a serious deterrent to FDI inflows. In addition, some forms of political instability can lead to instability in specific government policies that directly affect FDI projects. There is some evidence, however, that in this respect host-country political instability may not be as problematic as many investors believe. A study of governmental instability in developing countries found it to be only weakly related to instability in their restrictions on international funds transfers associated with FDI projects, and less so than among developed countries (Brewer 1983).

Instability in host countries therefore does not necessarily create an intolerable environment for successful FDI projects. There are many combinations of stability and instability, which vary considerably in how problematic they are for FDI. Some instances of host-country instability can be detrimental to the interests of FDI projects; other instances of host-country instability have relatively little bearing on FDI projects.

Another point that investors should keep in mind in their assumptions about

political instability is that developing countries are not uniformly less stable than industrial countries. Among the industrial countries, both France and Italy, for instance, have had periods of relatively frequent changes in governments. The U.S. political system has also exhibited elements of instability, with numerous assassinations and attempted assassinations of presidents and other national political figures since the mid-1960s. During the past decade there have also been unprecedented and largely unanticipated changes in the regulatory and tax environments affecting business. Finally, there has been a significant shift in the U.S. trade balance, as well as the international investment position itself, and accompanying shifts in the sentiments of the public and political leaders concerning trade and FDI policies. Such changes are hardly systemic revolutions, but they do create uncertainties in the business environment and complicate business planning and operations. Political instability, in short, is not unique to developing countries.

Some empirically based comparisons between developing countries and industrial countries challenge conventional perceptions of relative degrees of instability. In particular, fiscal policy was actually found to be less stable in nineteen industrial countries as a group than in nineteen large developing countries (Yu 1987). The relationship between the instability of a government and instability of fiscal policy, furthermore, has been found to be greater among industrial countries than among developing countries (Brewer 1985). Although these findings are restricted in their policy coverage and in the forms of instability included, the broad country coverage and redundancy in the findings tend to give them credence.

These findings suggest that stereotypic thinking about political instability in developing countries may be a major impediment to FDI. If potential investors' assessments of host-country stability were more specific and factual, they might find that a given prospective investment climate is more hospitable than first imagined. In sum, investors should be careful to be discriminating and not unduly skittish in their reactions to perceived instability in developing countries. They should not allow dramatic episodes -- such as those in Cuba in the late 1950s, Iran in the late 1970s, or in China in the late 1980s--to distort their perceptions of the investment climate for FDI projects in individual countries. Another area of potential distortion in investors' perceptions is that of more specific "political" or noncommercial risks, including expropriation, which is discussed in the next chapter.

Chapter 5

Host-Country FDI Restrictions and Incentives

As developing countries have passed through periods of changing attitudes toward FDI there has always been a widespread ambivalence--a positive interest in its potential role in development and a negative view of foreign control over the local economy. During the 1980s, however, there was a widespread shift in the balance toward a generally more positive attitude, particularly in reaction to the external debt payment problems caused by increased borrowing from commercial banks in the 1970s. The debt crisis led many countries to ease their restrictions on FDI and put increased emphasis on export-oriented FDI projects.

These shifting sentiments and policies concerning FDI have varied among host countries. Brazil, for instance, adopted a generally positive policy throughout the 1970s, when many other developing countries were still hostile toward FDI, but in the 1980s Brazil increased its sectoral FDI restrictions just as other countries were liberalizing theirs. A few countries--such as India (with a negative attitude) and Kenya (with a positive view)--have been relatively constant in their attitudes toward FDI for many years, with only marginal and occasional shifts.

One particular overall trend that has been clear over the past decade is the decline in instances of expropriation. For some countries the fear of foreign control during the period of early independence resulted in numerous expropriations. The incidence of expropriations, however, peaked in 1975 and has declined dramatically since then, as documented in table 5-1. Although expropriation has thus waned as a problem for investors, host countries have adopted diverse restrictions and incentives in an effort to influence the inflow of FDI. These FDI policy components are described below in summary form for host countries in general, the policy tendencies of the eleven selected host countries are then examined and three recent examples of major FDI policy change are considered.

Table 5-1. Trends in the Incidence of Expropriation, 1960-1985

Year	Number of Acts of expropriation	Number of Expropriating countries
1960	6	5
1961	8	5
1962	8	5
1963	11	7
1964	22	10
1965	14	11
1966	5	3
1967	25	8
1968	13	8
1969	24	14
1970	48	18
1971	51	20
1972	56	30
1973	30	20
1974	68	29
1975	83	28
1976	40	14
1977	15	13
1978	15	8
1979	17	13
1980	5	5
1981	4	2
1982	1	1
1983	3	3
1984	1	1
1985	1	1

Note: An act of expropriation is defined in the sources as the expropriation by one country in one year of firms in one industry.

Source: Kobrin (1984), table 1; and Minor (1988), table 1.

Summary of Policies

Host-country policies toward FDI can include a broad range of incentives and disincentives, which can be classified according to whether they affect a firm's revenues, input costs, or components of the value added. Within each of these categories, the effect of each policy instrument on the investor's return on equity can be identified as either positive or negative--possibilities that are summarized in table 5-2. The list in the table is so exhaustive and detailed, that it is unnecessary to comment on it at length. It can be mentioned, however, that a host government can easily create a complex combination of these elements that is at once both enticing and restrictive for investors and offers many opportunities for obfuscation and change on the part of government officials. As we shall note below, it is not only the degree of hospitality toward FDI embodied in such policies, but also their transparency and stability that are important to investors.

Table 5-2. Types of FDI Policy Incentives and Disincentives

Incentives/disincentives	Effect on after-tax return on owner's equity
Affecting Revenues	
Tariffs	+
Differential sales/excise tax	+ or -
Export taxes/subsidies (including income tax credits)	+ or -
Quotas	+
Export minimums	-
Price controls (or relief from)	+ or -
Multiple exchange rates	+ or -
General overvaluation of currency	-
Government procurement preference	+
Production/capacity controls	+
Guarantees against government competition	+
Prior import deposits	+
Transfer price administration	-
Affecting Inputs	
Tariffs	-
Differential sales taxes (and exemptions therefrom)	+ or -
Export taxes/subsidies (including utilities)	+ or -
Quotas	-
Price controls	+
Multiple exchange rates	+ or -
Subsidy or tax for public-sector suppliers	+ or -
Domestic-content requirements	
Prior import deposits	-
Transfer price administration	-
Limits on royalties, fees	-
Multiple deductions for tax purposes	+
Cash or in-kind grants for R&D	+

Affecting Components of Value-Added

Capital	
Direct subsidy	+
Cost of capital goods	
Tariff/sales tax exemption on imported/ domestic equipment	+
Prior import deposits	-
Local-content requirement for capital equipment	-
Limits on use of used equipment	-
Subsidized buildings	+
Subsidized cost of transportation	+
Cost of Debt	
Subsidized loans	+
Loan guarantees	+
Covering of foreign exchange risks on foreign loans	+
Priority access (including limitations on foreign firms)	+ or -
Cost of Equity	
Subsidized equity through public investment agencies	+
Exemption from capital gains taxes/ registration taxes	+
Dividend tax/waiver	+ or -
Guarantee against expropriation or differential treatment	+
Limitations on debt-equity ratio	-
Controls/taxes on remitted dividends	-
Minimum financial-in-kind ratio	-
Corporate tax	
Tax holiday/reductions	+
Accelerated depreciation	+
Special deductions and valuation practices (inflation adjustment, multiple plant consolidation)	+
Tax sparing and double-taxation agreements	+
Loss-carry-forward provision	+ or -
Contractual stabilization of rates	+

Labor

Wage subsidies (including indirect, that is, multiple deductions of wages for tax computations/reduction of taxes on labor)	+
Training grants	+
Minimum wage	-
Relaxation of industrial relations laws	+
Local labor requirements	-

Land

Cash subsidy for purchase/rental	+
Exemption/rebate of taxes on land	+

Not Classified

Limitations on foreign ownership
Free-trade zones
General preinvestment assistance
Countertrade requirements
Foreign exchange balancing requirements

Source: Guisinger and Associates (1985).

These FDI policy instruments are evident in a variety of combinations among the eleven selected host countries. Brazil, for instance, continues to be essentially hospitable toward foreign investors but retains restrictions in some industries (petrochemicals, telecommunications, and informatics). Moreover, there are joint venture requirements in some sectors, and there have been restrictions on borrowing and international remittances.

Argentina's policies continue to exhibit the instability that has been their hallmark since the late 1960s. Yet, except for the 1973-76 period, Argentina has generally welcomed FDI and adopted a moderately liberal FDI policy framework. In 1989 it took major steps to attract more foreign capital, especially by liberalizing its petroleum sector. During the 1980s, as a result of the debt crisis, there were periodic restrictions on profit and capital transfers.

Colombia has adopted an unusually strong sectoral orientation in its FDI policies. As a member of the Andean Group since 1970, Colombia adopted FDI policies with a tilt toward control rather than openness. Although its policies gradually were liberalized in the 1980s, they still favor extractive projects, particularly oil.

Mexico announced a major liberalization of its FDI policy in May 1989. Prior to that policy change, Mexico exhibited a strong tendency toward restricting foreign ownership, especially in the natural resources industries. The Mexicanization program nevertheless allowed and--even encouraged--substantial FDI in Mexico, particularly in manufacturing. Although Mexico has generally adopted liberal capital and foreign exchange controls, there were instances in the 1980s when restrictions were imposed on FDI-related remittances. Mexican FDI regulations also tend to be complex.

Kenya's FDI policy has included relatively liberal elements and generous incentives that have been available in selected cases. It has also implemented a comprehensive screening system, applied an extensive Africanization program, excluded FDI from several sectors, and imposed foreign exchange controls and borrowing limits on investors. Kenya's policy is presently marked by ambivalence in its basic direction and administrative details.

Nigeria has recently instituted a wide-ranging liberalization of its FDI regulations. The main outlines include a streamlining of the regulatory environment, a one-stop agency concept, simplification and enlargement of incentives, and privatization of parastatals, reversing prior foreign ownership restrictions. In the past, however, Nigerian policy consistently involved considerable complexity, uncertainty, and delays in the administrative process--and only marginal incentives. (See the section below on policy change for further details on Nigeria's policy.)

India maintains a restrictive FDI policy that discourages majority foreign ownership. Its approach to the regulation of FDI depends to an unusual degree on exchange controls, and there is a strong emphasis on technology transfer. Regulations are flexible depending on the degree of foreign and local ownership, with foreign ownership generally limited to 40 percent. There has been some liberalization of India's restrictions in recent years, but the overall FDI approach remains restrictive.

Indonesia's FDI policy regime has been marked by a mixture of both moderately liberal and restrictive elements, although on balance it has offered an increasingly hospitable climate and substantial relaxation of restrictions on FDI in recent years. Its restrictions on capital repatriation and profit transfers have been minimal, and fiscal incentives are supportive, but not as abundant as they used to be. At the same time there have been some limitations on foreign owned projects in agriculture, manufacturing, and services (these were significantly relaxed in 1989). In the energy sector, no foreign equity ownership is allowed, although other forms of foreign investment are permitted.

Malaysia's FDI policy is conspicuous among the eleven countries in its mixture of a liberal policy that reflects a positive attitude toward FDI and a restrictive policy that reveals a desire to control the ownership of business along domestic ethnic lines. The result is an FDI policy combining two "layers."[17] The first layer, which was put in place during the 1957-71 period, included few limits or other regulations; instead, the emphasis was on incentives for export-oriented projects that used local raw materials and ethnic Malay

labor. A major shift occurred in 1971 with the establishment of the New Economic Policy (NEP), which was designed to foster ethnic Malay ownership of businesses within Malaysia--a measure that had important consequences for FDI. A distinction was made in the amount of foreign ownership allowed, depending on whether a project was import-substituting or export oriented. Thus, new import-substituting FDI projects were required to have majority ownership by ethnic Malays at the outset, and any foreign ownership was required to be phased out by 1990. Majority foreign ownership was still permitted in export-oriented projects, but foreign ownership overall had to be reduced to 30 percent of total FDI stock by 1990. In 1986 these NEP ownership restrictions were relaxed, at least temporarily.

The regulatory framework for FDI in Thailand is relatively liberal, except that there are significant sectoral restrictions on FDI. Majority foreign ownership is not allowed in some manufacturing sectors and most service businesses. In sectors that are freely open to foreign investors, however, there is freedom of profit remittance and capital repatriation. In addition, Thailand's industrial policy includes a generous package of incentives that are equally available to foreign investors (in permitted industries) and domestic investors.

In Korea a liberal FDI policy regime has prevailed since 1984. Under the system in effect since then, foreign investment is allowed in most sectors, the percentage of foreign ownership is generally not limited, and capital and profits can be freely transferred. Prior to the liberalization measures in the early 1980s, however, there were extensive restrictions on FDI.

To assess the effects of these policies on FDI it is helpful to isolate several major dimensions of the policies.[18] One obvious dimension is the degree to which the host country is hospitable to FDI--a dimension that varies considerably both across countries and over time for any one country. In table 5-3 the eleven countries are listed with the degree of hospitality of their FDI polices during the two-and-a-half decades covered by the country studies, and then separately for the period since the early 1980s.

As examples of extreme opposites, Brazil, which has generally adopted hospitable FDI policies, has experienced disproportionately large amounts of FDI flows, while India has been the recipient of disproportionately low levels of FDI as a result of its relatively inhospitable policies. The relationship between a hospitable policy and FDI flows, however, is only approximate; the overall attractiveness of a host country's FDI policies depends on other dimensions as well, particularly their transparency and their steadiness (see Becsky, Lee, and Ordu 1990 and Frank 1980).

Both transparency and steadiness are important because they affect the degree of uncertainty that investors face as they contemplate FDI projects. Because investors are sensitive to the estimated risks as well as the projected returns associated with investments and because they always face commercial risks associated with doing business in a country, any additional uncertainty about the prospects for a given investment created by a lack of transparency or stability in a host country's FDI policies can be a serious deterrent to investors' investment plans. A lack of transparency in FDI regulations and incentives makes investors' estimates of the costs associated with host FDI regulations more problematic; it also makes their estimates of the benefits associated with the host FDI incentives more difficult to calculate. Furthermore, it is often difficult to determine the extent to which formal versus informal rules are actually operative in a given country at a given time. Some countries, however, tend to be rather formal in their approach, while others rely much more on informal interpretations of the rules in their application to individual cases. A frequent result of the informal approach, however, is that there are so many exceptions to the rules that the rules become practically meaningless and there is increased uncertainty for investors. Nevertheless, if the exceptions are codified, the formal rules become overly complex and confusing to investors.

Table 5.3 Major Dimensions of Host Country FDI Policies

Country	Steadiness	Transparency	Hospitality
Argentina	-/-	+/+	-/+
Brazil	+/+	+/+	+/+
Colombia	-/-	-/-	-/+
Mexico	-/-	-/-	+/+
India	+/+	+/+	-/-
Indonesia	+/+	+/+	+/+
Korea, Rep. of	-/-	+/+	-/+
Malaysia	-/-	-/-	+/+
Thailand	-/+	-/-	+/+
Kenya	+/-	-/-	+/+
Nigeria	-/-	-/+	-/+

Note Sign before the slash refers to overall record of the past two-and-a-half decades. Sign after the slash refers to the period since the early 1980s.

Source: These are summary judgments based on the evidence in Becsky, Lee and Ordu (1990), as supplemented by codings by Thomas L. Brewer and Aloysius Ordu.

Illustrative Recent Policy Changes

Investors, of course, find some policy changes to their liking, particularly changes that are comprehensive liberalizations of policy and are likely to remain in effect for an extended period of time; such policy changes can have a significant effect on FDI flows. Comprehensive packages of liberalization of policy are often followed by significant increases in FDI, and comprehensive packages of increased restrictiveness are similarly often followed by dramatic declines in FDI. (Becsky, Lee, and Ordu 1990, contains detailed analyses of several instances; a few are highlighted here for brief illustrative purposes.)

The correspondence between comprehensive FDI policy change and changes in FDI flows has been obvious in Korea. A generally liberal policy, including incentives for FDI, was in place from 1960 to 1973. After an initial period when FDI remained at modest levels, it increased substantially by the early 1970s. (An increase in restrictiveness in 1965 was largely directed at Japanese investors and not effectively implemented in any case.) In 1973 more extensive regulations were imposed, including major restrictions on ownership; foreign ownership was generally limited to 50 percent, minimum investment levels were established, and investments that competed with domestic Korean firms were rarely approved. As a result annual FDI flows declined during the mid and late 1970s.

FDI policy reversal embodied in a series of measures taken in 1980-84 subsequently reversed the trend in FDI flows. These measures greatly simplified and liberalized FDI policies. This reversal in policy was a response to the cumulative effects of the oil price increases of the middle and late 1970s--including negative growth in GDP in 1980, the first such decline in more than twenty years. The change in FDI policy was undertaken not merely for short-term balance of payments reasons, but also as part of a more comprehensive shift in policy that was designed to increase the competitiveness of Korean industry over the long term.[19]

In September 1980 an initial list of measures to encourage FDI was introduced. They increased the percentage of foreign ownership allowed in some projects, lowered the minimum size of investment, and allowed foreign participation in a broader range of projects. In July 1981 additional guidelines further reduced the restrictions. In September 1983 the government announced major simplifications in the FDI regulations, as well as the introduction of a "negative list" which allowed investments unless they were on the prohibited list (rather than the previous reverse practice of allowing only investments that were on the approved list), a change that was a significant liberalization, not merely a semantic or administrative gimmick. The new regulations became effective on July 1, 1984.

Recent FDI policy changes in Nigeria are also an example of the kind of comprehensive policy change that investors prefer. The effect on FDI flows is not yet apparent, however, because the major changes embodied in its industrial policy were only published in 1988.[20] Adopted as a consequence of the Structural Adjustment Program of 1986, the new Nigerian industrial policy represents a significant departure from previous FDI policy. The new approach attempts to create an FDI policy framework that is much simpler and clearer than in the past. In institutional terms, Decree Number 36 establishes an Industrial Development Coordination Committee (IDCC), which has the authority to approve preinvestment agreements, fiscal incentives, employment permits for foreigners, and foreign capital imports, as well as to provide policy advice to the federal government. The IDCC is a "one-stop" agency for FDI; unless an investor is informed otherwise, it can assume its application has been approved sixty days after submission.

The shift in Nigeria's approach to FDI policy includes changes in the substance of policy in addition to streamlining the FDI approval process. Although there are still significant restrictions on foreign ownership, the revisions of the Nigerian Enterprises Promotion Decree create a simpler policy and allow a much wider scope for new foreign investments. There is now a single schedule of restricted industries to replace the previous three schedules. The Privatization and Commercialization Decree of 1988 does not set any limits on foreign ownership of the state economic enterprises earmarked for complete or partial privatization. This privatization program is complemented by a new debt-equity conversion program potentially totalling $8 billion (28 percent of the external debt).

The new FDI policy also includes an extensive array of new fiscal incentives, including a 100 percent tax holiday for seven years, plus an additional 5 percent depreciation beyond the initial capital depreciation allowance for investments in disadvantaged areas. There are also tax reductions for the construction of infrastructure, research and development activities in Nigeria, and in-plant training programs.

FDI policy changes announced by Mexico in May 1989 also appear to be relatively comprehensive and should alter investors' perceptions of the investment climate. The intention of the new policy is to facilitate foreign investment in most sectors by making the FDI regulations simpler and more transparent and by allowing majority foreign ownership. Under the new regulations, foreign investment up to $100 million and majority ownership up to 100 percent will be allowed if seven explicit tests are met. In addition to the $100 million limit, the criteria are that financing of the project be entirely external; that the initial outlay be at least 20 percent of the total project cost; that the project achieve foreign exchange self-sufficiency within three years; that technology in keeping with environmental regulations be used; that the project be located outside the Valley of Mexico, Monterrey, and Guadalajara; and that the project create permanent employment and provide training for Mexicans. Any project meeting these tests will be approved.

Most sectors of the economy will come under these new regulations and thus will be more open to foreign investment. Some industries, however, such as petrochemicals and automotive parts, will be subject to different regulations. Special trust funds providing for majority foreign ownership for twenty years can be established in those industries. This plan is an application to industrial FDI projects of a program that has been used previously by the Mexican government for FDI projects in tourism--a plan that allows an additional thirty-year extension before expiration. After the expiration of the trust fund period the foreign investor must become a minority shareholder, so the scheme for these selected industries is in essence a program of deferred Mexicanization (Financial Times, May 25, 1989,p.8).

In sum, the degree of hospitality extended to foreign direct investors is only one of many important features affecting the attractiveness of host FDI policies. The transparency of FDI regulations is also important, because investors need to know in advance how the host-country regulations will be applied to their projects. If there is a high degree of variability in the interpretation of the regulations, or if it is necessary to obtain the approval of multiple host-government agencies (which may disagree among themselves), an otherwise hospitable host-country environment will become unattractive. Furthermore, steadiness in the FDI regulations is important to investors. Because foreign direct investors already face the normal commercial risks of doing business, plus the additional uncertainties of being foreign to the host country, constantly changing FDI regulations can be a significant deterrent to FDI flows. Consequently, host countries that exhibit not only hospitable but also transparent and stable policies provide investors with unusually attractive conditions for FDI.

Debt-Equity Swaps

In recent years debt-equity swap programs have been widely used as an additional incentive in FDI policies. Because the host government buys the debt instruments from the investor at a smaller discount than the investor receives from the commercial bank, the host government is subsidizing the investor's equity investment. Host governments commonly restrict the investment opportunities to selected sectors, and they also often restrict investors' profit remittances. After a slow start in the mid-1980s, debt-equity swaps initiated by developing countries had reached $8.9 billion by 1988 (World Bank, Quarterly Review of Financial Flows to Developing Countries, March 1989). In addition, there were informal conversions directly between creditors and debtors without formal government involvement, as well as exit bonds and other types of debt reduction programs, so the total magnitude of debt conversion transactions in that year amounted to $21.1 billion.

These transactions have been highly concentrated, with more than 90 percent in four Latin American countries: Brazil, Mexico, Chile, and Argentina. Among the other eleven selected countries, however, the recently developed program of Nigeria has attracted much interest. Asian trading firms already in Nigeria have been particularly active in using debt-equity conversions as a means of diversifying their portfolios into additional sectors. At the first three auctions between November 1988 and February 1989, limits of $40 million, $30 million, and $25 million were established to constrain the domestic inflationary impact of the conversions. Over the three auctions bids totalling $334.4 million were received, at discounts ranging from 36 to 58 percent.

Although these and other debt-equity swap programs may offer individual investors highly attractive opportunities for FDI projects, their ability to stimulate additional new investment that would not otherwise have taken place and their monetary and balance of payments consequences pose a variety of issues. In any case, such programs are likely to remain important, if specialized, features of the FDI policy framework of many countries for the foreseeable future.

Chapter 6

Policies of Home Governments and International Institutions

Home governments and international institutions have adopted a variety of policies designed to facilitate the flow of FDI to developing countries. They include guarantees for investors against noncommercial ("political") risks, project opportunity information services, and project finance assistance for investors, policy advice for host governments, dispute settlement services, and equity participation in projects. In addition, there are numerous data banks and other information services that are available for private sector investors as well as public sector organizations.

Although not directly focused on FDI, grant and lending programs of international institutions and developed countries that provide support for stabilization, structural adjustment, and privatization policies in host developing countries have important consequences for the macroeconomic and sectoral environment of FDI projects. Given the importance of these host-country conditions, as emphasized in chapter 4, such policies should not be neglected in any comprehensive analysis of the role of home governments and international institutions in facilitating FDI flows to developing countries. It is such a broad and complex topic in itself, however, that it cannot be discussed in any detail here. Rather, this chapter will focus on policies that are more directly concerned with FDI.

Guarantees

Numerous multilateral and bilateral treaties and other agreements have been developed to establish a legal framework for FDI guarantee programs and other policies. The latest and perhaps most significant is the establishment of the Multilateral Investment Guarantee Agency (MIGA) within the World Bank group. MIGA's programs of investment guarantees and other services are intended to supplement the activities of other international institutions and national governments. The creation of MIGA within the World Bank group marks the beginning of a new era in the public policy framework affecting FDI in developing countries. Despite the long negotiations required to draft its convention and obtain sufficient signatories to bring it into force, that a new international agency, created with the cooperation of both the developing and developed countries, is in itself an indication of a change in the climate of official opinion concerning FDI.

Since it has only recently become operational, MIGA's programs are still in the formative stage. It is likely to evolve into a participant in three broad areas of policy concerning FDI. The first and most obvious is to provide guarantees against noncommercial risks. Its role in this activity is designed to supplement the existing national home government programs and the programs of private "political risk" insurers--a role that has two components. The first component is based on MIGA's authority to issue guarantees on its own behalf for individual projects, which will tend to be projects in host-countries that are

not covered by the investors' home-country guarantee programs or projects that are otherwise not eligible for home-country coverage. The second component is based on MIGA's authority to issue guarantees for projects that are sponsored by home-government agencies, which will enable the home-government agencies to diversify their portfolios of guarantees.

Most developed countries have long had government agencies that issue guarantees against noncommercial risks. Like MIGA, many of these national programs can protect investors against losses from expropriation, restrictions on profit remittances and other funds transfers, war and other forms of violence, and in some instances, contract repudiation as well. Although these home-government investment guarantee schemes are well known, they are not widely used. In the early 1980s only about 9 percent of the total FDI stock in developing countries from OECD countries was covered by their home country investment guarantee programs, and only about 20 percent of the flows at that time were being covered (Shihata 1982, p.12). There have been, however, large variations in the extent of coverage among countries--with Japan at one extreme (over 50 percent coverage) and several West European countries at the other (less than 5 percent coverage). The generally low levels can be attributed to a variety of factors, including restrictions on eligibility based on national interest considerations, limited financial resources of guarantee agencies, and concerns about portfolio diversification.

For companies from the U.S. this issue is investigated in more detail in a recent study that surveyed multinational corporations concerning their investment decisions in developing countries (Wallace, forthcoming). Among the cooperations covered, roughly one-quarter were insured one way or the other. Most of the companies were at least partially protected under the scheme of the U.S. government's Overseas Private Investment Corporation (OPIC), and another 8 percent were thinking about becoming insured by OPIC. MIGA, although just established, received much attention, with 13 percent of the companies either considering or already committed to MIGA. Some companies had participated in an insurance scheme in the past and later withdrew; they had decided to reduce their foreign investment to a level low enough to make risk insurance obsolete. Most companies that are <u>not</u> insured against political risk considered this issue critical to their investment decision, while only about 60 percent of the insured companies consider this issue to be critical. Thus, there are two kinds of companies when risk behavior is considered: those which perceive the reduced political risk (for example, the declining number of expropriations) correctly, and therefore feel less of a need for insurance, and those which do not get involved in more detailed risk considerations at all and avoid high risk regions.[21]

There are also a small number of private political risk insurers. Because these are private organizations, they have great flexibility in the kinds of coverage and projects and the host-country locations they choose to cover compared with home government agencies. Their fees are also higher and the duration of their coverage shorter than those of the government programs.

Other Issues

Although MIGA's guarantee program received the most attention during its formation, its informational and advisory services for governments and investors, as well as its potential to become a key international institutional forum for FDI policymaking are also central to its mission.

MIGA's informational and advisory services for investors will supplement an array of programs already in existence under the auspices of national governments and international organizations. For instance, the United Nations Industrial Development Organization has an investment promotion office in New York. As an example of a home government investor information service, OPIC maintains an Opportunity Bank listing information about projects for which host governments seek investors.

In addition to the information activities of such FDI investment guarantee agencies, there are also other agencies that can provide prospective investors with information about projects and the investment climate in developing countries. In the U.S. these include the Commerce Department, the Agriculture Department, the Trade and Development Program of the U.S. International Development Cooperation Agency, and other agencies as well. Furthermore, many host governments have investment promotion offices in New York and other cities to supplement the promotional activities of their own embassies and ministries. These diverse governmental sources and the numerous commercial and other nongovernmental sources provide investors with ample and readily available sources of information that they might seek for planning and operating particular projects.[22]

In addition, many home governments provide project finance assistance through programs of loans to investors, loan guarantees, and equity participation. The funding for these programs is often modest, but their marginal contribution to individual projects can nevertheless be significant. A study of six such programs found that most of them made annual commitments to corporations totaling approximately $100-$800 million each during FY1983 (Ghadar Associates 1985). The study included agencies of France, the United Kingdom, the Federal Republic of Germany, the Netherlands, and the European Community. Among international agencies, the project finance activities of the International Finance Corporation (IFC) are also well known.

The existing array of home government and international institutions designed to facilitate FDI in developing countries is comprehensive. Nevertheless, there will always be questions about the "additionality" of these programs, that is, the additional amount of FDI that is made because of these programs that would not otherwise be undertaken. The evidence indicates that these programs do have an effect on particular projects in rather direct ways. For instance, a study of the additionality of the programs of OPIC concluded that 25 percent to 82 percent of the investments covered by OPIC would not have been undertaken without that coverage (Arthur Young and Company 1982). On the basis of an extrapolation of those findings for OPIC and depending on the assumptions about the capitalization levels and substitution levels for MIGA's program, MIGA's guarantee program could stimulate annual additional FDI of several hundred million dollars a year (see Moran 1986).

The most important element of these programs, however, may be their effects on the general perspectives and policies of investors and host countries. As far as host governments are concerned, the effect of the international institutions, in particular, includes pointing the direction toward new policies and providing policy reform assistance. In this way programs can contribute to the development of a more favorable host-country investment climate. For investors, the active interest of international institutions in projects and their more general educational and informational function can alter investors' perceptions of the host-country investment climate, and thus facilitate FDI.

Chapter 7

Outlook for the Future

The eleven selected host countries present a wide range of prospects for FDI and illustrate the diverse array of factors that influence those prospects. Comprehensive recent changes in FDI policy and macroeconomic policy in Mexico and Nigeria offer investors the prospect of significantly more attractive investment climates, although concern about future economic stability in Mexico and political stability in Nigeria could still hinder investment. The net result, however, is that average annual FDI flows are likely to increase for those two countries over the next five years.

In Brazil significant FDI sectoral restrictions and economic instability constrain FDI, but a generally hospitable climate toward FDI prevails, and in the long term Brazil's market size will continue to be an attraction for FDI. The net effect of these conflicting forces is likely to be modest growth in FDI flows over the next five years. In contrast, the recent political changes in Argentina will create additional uncertainties for prospective foreign investors, who will likely adopt a wait-and-see posture for a year or two as they assess the investment climate, and thus contribute to declines in FDI flows.

The liberalization of FDI policies by Korea, in combination with economic stability, is likely to encourage continued increases in annual FDI inflows. In Indonesia, Malaysia, Thailand, and Kenya, the absence of any dramatic change in the mixture of forces affecting FDI flows suggests average annual investment over the next five years at similar or slightly higher levels than during the past five years.

Among the eleven selected countries the greatest potential for increased FDI is in India. Given its market size and relative political stability, the basic economic and political conditions offer foreign investors an attractive environment. Yet, compared with the other ten countries, the ratio of FDI to GDP is by far the lowest in India. If the ratio of FDI flows to GDP for India reached the mean levels of the other ten countries for the 1983-87 period, there would be more than a twentyfold increase over the levels during the comparable period for India. There is already a stock of FDI in place in India, and it could serve as a basis for additional FDI. There is, furthermore, a considerable degree of diversity in both the number of source countries represented and the sectoral distribution. For India to attract FDI flows, liberalization policies would have to be adopted.

Global Changes

Aggregate FDI flows to all developing countries are likely to average about SDR15 billion a year in the early 1990s. They are not likely to exceed SDR20 billion per year before 1993. The sectoral prospects for FDI vary considerably for minerals, agriculture, manufacturing, and services--both because of variations in the economic forces that drive FDI and because host-country FDI policy profiles are likely to continue to differ across sectors. For the

services sector, for instance, increasing real incomes in middle- and upper-middle-income developing countries will increase market size, and thus their attractiveness as locations for FDI in services. At the same time, however, a strong tradition of restrictiveness in services trade and investment policies is likely to constrain FDI.

The policies of the developed countries are not likely to yield significant increases in the total magnitudes of FDI flows to developing countries within the next three years unless economic reforms in many developing countries improve investment climate substantially. The developed countries' programs to promote FDI in developing countries through guarantees against noncommercial risks and other means have been in place for many years. Even if there were major increases in these promotional efforts in the next year or two--which is unlikely--there would be a lag of several years before they had much effect on FDI flows.

The implementation of the European Community's (EC) 1992 program of further reductions in barriers to intra-regional trade and investment is already having an impact on FDI patterns. Thus far, the most important effect is that corporations based in the United States and Japan have been expanding inside the EC to serve the larger European market and to protect themselves from the effects of the more restrictive external trade barriers. To the extent that their increased FDI activities in Europe use their scarce financial, managerial, and other resources, these corporations' FDI activities in developing countries will be limited. This would be particularly the case as long as the United States remains the preferred destination of Japanese FDI.

Also, European firms themselves will be increasing their investment within Europe in anticipation of the growth of their regional markets, which will also reduce their interest in FDI in developing countries. In addition, as the reduction of intra-regional barriers makes imports from developing countries less competitive with goods produced in Europe, there will be less incentive for export-oriented FDI projects in developing countries that serve European markets. Over the longer term, however, the income-increasing effects of further integration in Europe will increase the demand for imports, including imports from FDI projects in developing countries.

Nevertheless, the net effect of all these factors on FDI in developing countries is unlikely to be dramatic. FDI, particularly in the primary sector is unlikely to be affected much at all, at least in the short term, and will probably be positively influenced in the long term. In the secondary sector, because the production processes in many manufacturing industries, such as motor vehicles, are already highly integrated internationally and include component and assembly operations in developing countries, increased manufacturing FDI in Europe is unlikely to replace FDI projects in developing countries. Finally, FDI in services in developing countries is more affected by local host-country market conditions and FDI policies than by conditions in Europe. In sum, then, the consequences of the EC 1992 program may reduce FDI flows from developed to developing countries somewhat below what they would have been over the next several years, but it is unlikely to have a significant effect.

The United States will continue to attract large amounts of FDI, particularly from Japan, as the U.S. trade deficit persists. Thus, macroeconomic conditions and policies in the developed countries will continue to be major influences on FDI flows to developing countries, just as the macroeconomic conditions and policies of the developing host countries themselves will continue to be important influences.

Conclusions

Any consideration of the future of FDI in developing countries should not be limited to an analysis of aggregate quantities of flows of resources to developing countries because the effects of FDI can often be understood best at the level of individual projects. FDI is qualitatively different because it consists of a bundle of services with diverse effects on the local economy and projects are integrated into large, often global, corporate networks.

FDI projects thus make distinctive contributions to the development process. They bring in new production and other technologies, new managerial skills, new marketing and finance opportunities, new approaches to a variety of managerial issues, and new relationships with the world economy. Even in cases where the FDI project is in the form of an acquisition of existing companies, the new foreign owner often makes changes in operations and strategic orientation.

Such changes may not only contribute to the economic development process, but also have controversial political and cultural consequences, as well as economic costs. For example, highly protective incentives to attract FDI may result in distorted resource allocation. In any case, questions about the distribution of the costs and benefits of FDI, and its noneconomic effects, will always be raised. Although the recent changes toward more positive attitudes about FDI in many developing countries are surely indicative of a much more receptive climate of opinion, some degree of ambivalence and a consequent desire to control foreign-owned business will continue. The future of FDI in developing countries will therefore be shaped to a great extent by the government-business interactions involved in the entry negotiations and the operations of individual projects. There will consequently continue to be significant variations across industries and host countries in the patterns and trends of FDI in developing countries.

Such variations do not alter the central fact that a new FDI era has emerged--an era marked by a greater recognition of the benefits of FDI in the development process. In this era, the focus of attention has shifted to the specific, tangible ways that host governments (as well as home governments and international institutions) can change their policies and devise new mechanisms to facilitate the flow of FDI to developing countries. It is an era of pragmatic cooperation and policy innovation.

To this end, there is an important scope for the World Bank group, especially with the establishment of MIGA, to assist host governments in their efforts to translate more positive attitudes about FDI into tangible policy reforms, will be increasingly important.

Appendix 1

Although the OECD has continued to collect and publish FDI data, this information is generally less comprehensive and authoritative than IMF data. The OECD data are source-country based and include only FDI outflows of OECD member countries; the geographic scope of the data is therefore less comprehensive than that of the IMF figures. As FDI outflows from non-OECD countries increase, the limited source-country coverage of the OECD data thus becomes increasingly problematic, especially for some individual recipient countries for example, Malaysia. OECD data are also less comprehensive than IMF data in their treatment of FDI-related borrowing. For any given host country, OECD figures on FDI consequently tend to be somewhat lower than corresponding IMF figures, although they are not uniformly so. Furthermore, neither OECD data nor IMF data are very helpful for sectoral analyses; instead the UNCTC data are the best for this purpose.[5]

For some countries and time periods the FDI data are marked by considerable variability; this can be true for time trends as well as absolute magnitudes in any one year. Nevertheless, there are moderately strong positive linear relationships among the data series for most countries over the 1968-86 period so that the basic long-term patterns and trends are similar across data sets. Table 7-1 contains correlations among the data series for the eleven countries. In addition to Nigeria, the most problematic countries are Indonesia and Malaysia. OECD data are especially deficient for Malaysia because they do not include the large amounts of FDI from non-OECD countries. Neither the OECD nor the IMF alone is entirely satisfactory for Indonesia because of gaps in sectoral coverage in the IMF data and the omission of FDI related borrowing in the OECD data. (The new data base being developed at the UNCTC corresponds most nearly to national or Institute for Research and Information on Multinationals [IRM] data in table 7-1).

Table 7-1: Correlations among Data Series for FDI Flows

Country	IMF-OECD data	IMF-national (or IRM)[a] data	OECD-national (or IRM)[a] data
Argentina	.63	.96	.78
Brazil	.66	.47	.57
Colombia	.84	.71	.59
Mexico	.50	.72	.55
India[b]	n.a.	n.a.	n.a.
Indonesia	.27	1.00	.24
Korea, Rep. of	.57	.91	.60
Malaysia	-.06	.97	-.06
Thailand	.75	n.a.	n.a.
Kenya	.48	.89	.68
Nigeria	-.02	-.07	.61

n.a. Not available

NOTE: Correlation coefficients are based on 1968-86 data.

a. Data for India are only from the OECD.
b. IRM data are used for Indonesia, Malaysia, and Thailand; national data are used for the other countries.

Source: Computed from Becsky, Lee, and Ordu (1990), tables 2.2, 3.2, 3.9, 3.13, 5.2, 5.9, 6.2, 6.6, 7.1, and 8.5. The IMF data are from the Balance of Payments Yearbook and International Financial Statistics. The OECD data are from Development Cooperation Review and International Investments. The IRM data, which correspond closely to recipient country national government data, are from Dunning and Cantwell (1987). The national data are from central banks and FDI agencies in host countries.

The data for some countries are unusually problematic. Argentine data reveal major inconsistencies among OECD, IMF, and Argentine national sources; there are also more gaps and fewer refined indicators for the components of FDI flows to Argentina than for most other countries. For Indonesia, a combination of OECD and IMF data is required for some analyses; for the Republic of Korea, national data provide the most comprehensive coverage.

The Nigerian data reveal some major discrepancies among the data sources. An extreme example is the Nigerian data for the three-year period, 1979-81, a time of governmental and FDI policy change and uncertainty (see table 7-2). Depending on the source used, one finds that the level of annual FDI flows (in current U.S. dollars) increased from 1979 to 1980 and again from 1980 to 1981, for a net increase of $500 million in the annual flows over the two-year period (as in the OECD data); first decreased and then increased, for a net increase of $239 million in the annual rate over the two years (IMF data); or first increased and then decreased, for a net decrease of $256 million in the level of annual flows (Central Bank of Nigeria data). It should be repeated that this is an extreme example, but it does highlight the problems of attempting to analyze precisely the short-term effects of at least some individual events on the basis of more than one data source.[6]

For Nigeria, as well as most of the other countries, however, the IMF data are best in their comprehensiveness of coverage, clarity of methodology, and availability for recent years. Furthermore, as indicated in table 7-1, the correlations of the IMF data with data from other sources are moderately strong for most countries.

Table 7-2: Alternative Data Sources for FDI Flows to Nigeria, 1979-81
(current US$-millions)

Source	1979	1980	1981	1979-81
OECD	-49	206	451	608
IMF	304	-734	543	113
National[a]	481	855	225	1561

a. Central Bank of Nigeria

Source: Becsky, Lee, and Ordu (1990), table 8-5.

For the most part, the data presented here are national data that were created by aggregating project data reported to host governments (in some instances by home governments). Because governments are generally anxious to preserve the confidentiality of individual investors' transactions and their stakes in individual projects, it is not feasible to expect the refinement of readily available, official FDI data to the level of individual projects. In some instances governments do not report aggregate data even at the industry level because the aggregate numbers would also reveal the numbers for individual projects.

The relative importance of individual projects can consequently be obscured in the aggregate data. An example is the Japanese liquified natural gas (LNG) projects in Indonesia initiated in 1981.[7] With a total FDI value of $5 billion, the two LNG contracts made Japan the biggest foreign investor in the Indonesian energy sector and in total FDI, thus surpassing the United States in both categories. The relative magnitude of this project can be appreciated by comparing the $5 billion project with total annual FDI inflows at the time on the order of $100-200 million, an accumulated total FDI stock of approximately $9 billion, and previous accumulated Japanese stock of $2.5 billion.

Finally, it should be noted that because this paper focuses for the most part on flows of FDI rather than stocks,[8] there is one commonly noted data problem that is only occasionally relevant in this particular study --the use of book values as the basis of FDI stock data. Such data do not reflect current market values and the effects of inflation. Again, because the focus of the present volume is on flows, with only occasional reference to stocks, this particular FDI data problem is not central to the study.

NOTES

1. The discussion is largely nontheoretical in nature--an orientation that is appropriate given the paper's emphasis on the effects of public policies on FDI and the unsettled and incomplete state of FDI theory. Selected items from the theoretical literature on FDI include: Dunning (1988), Buckley and Casson (1976), and Rugman (1981). New York, Columbia.

2. For additional information about definitional issues and associated data issues concerning FDI, IMF (1985, appendix 1; 1977, chapter 18 and appendix E; 1981), OECD (1983), World Bank (1979, annex 1), Becsky, Lee and Ordu (1990, chapters 1 and 2)

3. The present paper represents an updated sequel to two previous World Bank Staff Working Papers (1973, 1979). In addition, see the study by the Research Department of the International Monetary Fund (1985).

4. IMF data were found to be the best source for most of the eleven countries in the country studies volume. India, Indonesia, Korea, and Malaysia are partial exceptions. See the relevant country studies chapters in Becsky, Lee, and Ordu (1990) and table 4-1 in the present volume.

5. The UNCTC data base relies on information from the host countries and is, in some cases, supplemented by OECD data.

6. These and other issues about the data sources are discussed at length for the individual countries in Becsky, Lee, and Ordu (1990).

7. Becsky, Lee, and Ordu (1990), pp. 173-74.

8. Unless otherwise indicated, the flows reported here are "net inflows," meaning investments in the host country net of divestments and repayment of principal on FDI-related loans. Except for table 2-6 and the accompanying discussion, investments abroad (outside the host country) and the associated transactions are ignored.

9. This is net of disinvestment.

10. All data in this paragraph are from Becsky, Lee, and Ordu (1990). Also see Svetlicic (1986), Kumar and McLeod (1981), and Wells (1983).

11. Dunning and Cantwell, (1987), table 8-17, p. 819. Data are for 1974-83.

12. United Nations Centre on Transnational Corporations, (1988), table I-3, p. 25, cites $159.0 billion as of 1985.

13. The fluctuation in the data shown in Table 2-8 is at least partly due to the fact that it is drawn from two different sources.

14. Because these charts are based on constant U.S. dollars, the descriptions of the time trends occasionally differ from the descriptions of some periods based on current dollars for the individual countries in Becsky, Lee, and Ordu (1990).

15. Based on IMF data. As noted in the appendix to chapter 1, a different pattern is evident for NIgeria during the early 1980s in other data series.

16. The principles of comparative advantage theory suggest two generalizations about the attractiveness of countries for FDI projects in view of their basic economic conditions. Because every country has a comparative advantage in producing something, every country is also at least potentially an attractive location for some kinds of FDI projects. Yet, because every country's comparative advantage is subject to change over time, a country that is a relatively efficient production location for a given product at one time may no longer enjoy a comparative advantage in the same product some year later. Thus, there are likely to be shifts over time in the geographic location of production facilities for a given product as countries' comparative advantage profiles shift.

17. Becsky, Lee, and Ordu (1990) considers the "layers" of Malaysia's FDI policy in chapter 5.

18. There are indisputably causal connections between public policies and FDI flows, but it is often difficult to isolate and verify those connections with precision. The connections are frequently observable at the level of individual FDI projects, but this study is based on information that has been aggregated at the national level of analysis. Nevertheless, the findings and conclusions of this study would presumably be supported by project-level data and case experience.

19. Although the main outlines of the impact of this particular series of policy changes are clear, it is difficult to identify the precise timing and magnitudes of the effect of the policy change on FDI flows. One reason is that the change in policy occurred over several years. Nearly four years elapsed from the initial signal of a policy reversal until all the changes were in place. A second reason it is difficult to measure the precise effects of each policy change is that actual FDI flows inevitably lag behind applications and approvals. In this instance, though, the increase in approvals makes clear that the changes in policy resulted in changes in planned FDI projects.

20. See table 8-10 in Becsky, Lee, and Ordu (1990) for the results of a 1988 survey of corporations with plans to invest in Nigeria. This discussion of Nigerian policy draws directly and extensively on the analysis in chapter 8 of that volume.

21. The tendency toward risk awareness is also reflected in other countries' data on FDI stock in developing countries. German stock data, for example, showed a declining share of FDI in developing countries and an increasing trend of buying existing companies. This, however, is not only the result of a decreasing willingness to invest in high-risk regions, but also to a large number of new investors who are more likely to start investing in familiar geographical regions.

22. The situation for macro-level aggregate data analysis for public policy research and analysis is more problematic, as we have noted elsewhere in this volume. A new comprehensive information system is being developed by the United Nations Centre on Transnational Corporations and will result in a Directory of Data on Transnational Corporations and an on-line data base for external users. The data base includes extensive information on FDI flows, stocks, and international funds transfers; parent corporations and their affiliates; international agreements and national policies; and bibliographies of sources for each country. (United Nations Centre on Transnational Corporations, "Data Base and Directory on Transnational Corporations," October 6, 1988) The data base is an expanded and updated version of Dunning and Cantwell (1987).

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